UNITED NATIONS CONFERENCE ON TRADE AND DEVELOPMENT

# TRADE AND DEVELOPMENT REPORT, 2010

## OVERVIEW

UNITED NATIONS

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UNITED NATIONS CONFERENCE ON TRADE AND DEVELOPMENT
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UNCTAD/TDR/2010 (Overview)

# OVERVIEW

*The global upturn from what is considered the worst economic and financial crisis since the 1930s remains fragile, and a premature exit from demand-stimulating macroeconomic policies aimed at fiscal consolidation could stall the recovery. A continuation of the expansionary fiscal stance is necessary to prevent a deflationary spiral and a further worsening of the employment situation.*

*It is becoming clear that not all countries can rely on exports to boost growth and employment; more than ever they need to give greater attention to strengthening domestic demand. This is especially true today, because it is unlikely that the United States' former role as the global engine of growth can be assumed by any other country or countries. The shift in focus on domestic-demand-led growth is necessary both in developed and emerging-market economies with large current-account surpluses and underutilized production potential in order to prevent the recurrence of imbalances similar to those that contributed to the outbreak of the global financial crisis. But it is also important for many developing countries that have become heavily dependent on external demand for growth and for creating employment for their growing labour force.*

*Unemployment is the most pressing social and economic problem of our time, not least because, especially in developing countries, it is closely related to poverty. The fallout from the global crisis*

*has exacerbated what were already sluggish labour markets in most countries even before the crisis erupted. Since 2008, the global employment-to-population ratio has been exhibiting a sharp decline, and many countries are now facing the highest unemployment rates of the last 40 years. Therefore employment creation needs to be made a priority in economic policy.*

*In this context, it is important that the macroeconomic policy framework be strengthened to promote sustainable growth and employment creation in both developed and developing countries. Past experience and theoretical considerations suggest that a sustainable growth strategy requires a greater reliance on domestic demand than has been the case in many countries over the past 30 years. In such a strategy, job creation for absorbing surplus labour would result from a virtuous circle of high investment in fixed capital leading to faster productivity growth with corresponding wage increases that enable a steady expansion of domestic demand. Especially for developing countries, this may call for a rethinking of the paradigm of export-led development based on keeping labour costs low.*

## Global economic recovery remains fragile

After a contraction of almost 2 per cent in 2009, global real gross domestic product (GDP) is expected to grow by about 3.5 per cent in 2010, with a re-acceleration of output growth in most regions. Exceptions are the European Union (EU) and some transition economies, where recovery is proving to be much slower. But the rebound from recession will not endure if it continues to be based on temporary factors, such as inventory cycles and exceptional fiscal stimulus programmes, and if the shortcomings that caused the crisis, such as unregulated financial systems, income inequality and global imbalances, persist. Unless new sources of dynamism can be found, growth rates will probably decline again in most countries in 2011.

In developed countries, financial rescue packages by governments in 2008 and 2009 prevented the collapse of financial markets, while supportive fiscal and monetary policies partially compensated for sluggish private demand. Most of these economies returned to positive growth rates between the second and fourth quarter of 2009. However, final domestic demand has remained generally weak owing to continued high unemployment and restrained private consumption. Investment has been discouraged by idle productive capacities, uncertain demand expectations and more difficult access to credit.

Among developing and transition economies there have been wide variations in both the depth of the recession and the vigour of the recovery. The financial shock seriously affected those emerging-market economies that had been running current-account deficits and depended heavily on net capital inflows. Many of them were transition economies which were forced to apply restrictive macroeconomic policy responses, in some cases under IMF-led programmes.

The financial turmoil had little direct effect on low-income countries that are largely excluded from international financial markets and on emerging-market economies that had avoided large external deficits and accumulated significant international reserves in the years prior to the crisis. Most Asian and Latin American emerging-market economies were able to contain a rise in unemployment during the crisis and achieve a rapid recovery of domestic demand. This served to drive their output growth in 2010. Indeed, in the first quarter of this year some of the large emerging-market economies in these regions achieved two-digit growth rates.

## World trade and commodity prices support growth in developing countries

World trade, which had plunged by more than 13 per cent in volume and by as much as 23 per cent in value in the first half of 2009, started to recover in mid-2009, and the recovery was much faster in developing than in developed countries. By April 2010, the volume of trade of emerging-market economies had reached its previous peak of April 2008. Higher export volumes and a rebound in primary commodity prices from their lows of the first quarter of 2009 boosted national income and fiscal revenue, especially in Africa and West Asia.

The projected growth rate for Africa in 2010 as a whole is about 5 per cent, and closer to 6 per cent for sub-Saharan Africa (excluding South Africa). In Latin America, GDP is also forecast to expand by some 5 per cent in 2010. In some countries of the region growth could exceed 6 per cent, but it is likely to be more moderate in Central America and the Caribbean. In South-East Asia, GDP should rise by about 7 per cent in 2010, and in East and South Asia most countries are on track to return to their pre-crisis growth rates. In several countries of Central and Eastern Europe and the Commonwealth of Independent States (CIS),

recovery is likely to be slower owing to high unemployment, wage cuts and constraints on government spending.

Primary commodity prices began to rise once more in 2009 and the first half of 2010, particularly in metals and minerals, and energy products, especially crude petroleum. These were also the commodities that had experienced the sharpest fall in prices in the second half of 2008 as they are the most closely linked to global industrial production. The prices of agricultural commodities grew more moderately, although those of agricultural raw materials rose by more than 50 per cent from their trough. This upward trend continued partially into 2010, and in spite of their sharp decline in the second half of 2008, prices for all commodity groups during 2009 and early 2010 have been well above their average of the 2000s. Robust demand from the rapidly growing emerging-market economies, mainly China, has contributed to the recovery of commodity prices, but, as in previous years, price developments have also been strongly influenced by the behaviour of financial investors.

Food prices have remained relatively low since their fall in the second half of 2008, due mainly to bumper harvests in cereals, vegetable oilseeds and oils, and to an easing of pressure on cereal and oilseed production for biofuels. In food markets, inventories have been replenished to more comfortable levels. However, although forecasts suggest good harvests in 2010, food security is still a pressing problem in many developing countries.

Strong countercyclical macroeconomic policies in most developed and emerging-market economies helped the global economy turn the corner in mid-2009, although rates of recovery varied across regions and countries. However, during the course of 2010, there has been a reorientation towards fiscal consolidation in Europe, implying a shift towards a restrictive fiscal policy stance and thus a withdrawal from an expansionary demand stimulus from the beginning of 2011 onwards. This could compromise further recovery since, in most developed countries, especially in Western Europe, private demand, so far, has only

partially recovered from its trough. It would therefore make countries overdependent on exports for their growth and could lead to the re-emergence of current-account imbalances of the kind that contributed to the build-up of the financial and economic crisis in the first place. In any case, if too many big countries rely on higher net exports, they cannot all be successful.

## Developing economies lead the global recovery

The strength of the global recovery has varied in line with how aggressively stimulus measures have been applied by different countries. China, which was severely hit by the slump in its key export markets in developed economies, was the most decisive in fuelling domestic demand through stimulus measures. Its GDP growth accelerated already in the second quarter of 2009, as did growth throughout East and South-East Asia, once again contributing to an increase in employment and production capacities. China, and to a lesser extent India and Brazil, are leading the recovery, not only in their respective regions but also in the world.

As interest rates in the United States and other developed countries are near zero, and are likely to remain very low in the absence of inflationary pressures, any tightening of monetary policy in emerging-market economies as a result of their faster recovery and to avoid the risk of overheating may widen interest rate differentials in favour of these latter economies. This, coupled with a renewal of risk appetite on the part of financial investors, could well lead to an increase in net private capital flows to the emerging-market economies. Indeed, their stock market indices are already showing a substantial improvement. This, in turn, could generate upward pressure on their exchange rates and may require currency market intervention with a view to preventing exchange-rate appreciation as well as to provide "self-insurance" against speculative carry trade operations.

## The recovery in developed countries resembles pre-crisis patterns

While developing countries are leading the recovery, it remains fragile and uneven in developed countries. Among the developed countries, in a repeat of global pre-crisis patterns, the United States has witnessed a stronger recovery in domestic demand than the leading current-account surplus countries – Germany and Japan. But in moving forward, the United States has to deal with the problem of 8 million crisis-related job losses, and it faces strong headwinds as the fiscal stimulus peters out in the course of 2010. In 2011, its overall fiscal stance could even become restrictive as fiscal retrenchment is expected at the state and local levels. Moreover, the housing market and house prices remain depressed.

Recovery in Germany and Japan continues to be characterized by their strong reliance on exports. The main source of export stimulus has increasingly shifted away from the United States towards China and other emerging-market economies. And weak domestic demand in Germany is no longer being offset by more buoyant domestic demand elsewhere in the EU. Europe has become the centre of the global crisis and a laggard in the global recovery, as its home-grown problems add to the vulnerability of its shaky financial markets.

## Instability and uncertainty in Europe

In the first half of 2010, stress in the markets for some European countries' public debt escalated. The relevant European authorities, assisted by the IMF, responded with a support package for Greece and

other European countries that may face difficulties, which helped to calm financial markets. However, doubts remain as to how the underlying real regional disequilibria in competitiveness will be addressed, and how the draconian fiscal retrenchments and wage cuts will affect recovery of domestic demand.

Following Germany's lead in committing to unconditional fiscal consolidation to regain market confidence, fiscal austerity is set to spread across Europe in 2011. The prospect of a premature exit from stimulus in Europe has heightened the risk of a double-dip recession in that region, or even worldwide. In the eagerness to embark on fiscal consolidation, it is often overlooked that a double-dip recession, through its negative impact on public revenues, could pose a greater threat to public finances than continued fiscal expansion, which, by supporting growth of taxable income, would itself augment public revenues.

## A weakening of global coordination and of the G-20 process

Continued global coordination of efforts directed at crisis management and systemic reform remains an acute challenge. At this stage, coordination primarily concerns the free-rider problem. As a rule, governments should withdraw stimulus only after achieving a full recovery of private domestic demand in their country. If it is withdrawn prematurely, they have to rely on exports for recovery, thereby shifting the burden of sponsoring a demand stimulus onto others. Ideally, the timing of an exit from stimulus should contribute towards a rebalancing of global demand.

At the peak of the global crisis, the G-20 managed to agree on the need for coordinated measures, as the sheer severity of events discounted any possible alternative to stimulus. Apparently that moment has passed: views on how to tackle the current challenges vary widely, and major

differences in policy visions have resurfaced. Policymakers in the euro area believe that fiscal austerity will support rather than harm growth by creating confidence. United States policymakers, on the other hand, fear that continued stagnation of domestic demand in Europe may threaten the global recovery.

In the current situation, the short-term effects of fiscal austerity, including job losses, are unlikely to be offset by sharply falling interest rates and greater confidence in long-term prospects. And the depreciation of the euro in the first half of 2010 essentially means exporting unemployment to the rest of the world. Failure to coordinate policies at the G-20 level, with a more expansionary overall stance, raises the prospect of a re-emergence of global imbalances, especially among developed countries. This would run counter to the declared objectives of the G-20 and signify a breakdown of the G-20 process of international cooperation. It would also mark a real setback: macroeconomic policy coordination among the G-20 countries is of crucial importance, as major adjustments of demand patterns are expected to occur in the United States and China that will have a considerable influence on prospects for growth and employment in the world economy.

## Adjustments in opposite directions in the United States and China

In the United States, a downward adjustment of consumption will be unavoidable unless wages grow strongly, which seems unlikely. For almost 10 years before the financial crisis, personal consumption in that country had been rising considerably faster than GDP despite a decline in the share of labour compensation in GDP. Greater consumer spending by reducing savings and incurring debt was possible in a financial environment where credit was easily accessible and where a series of asset price bubbles created the illusion of increasing household wealth. But with the collapse of the United States housing market, households

were forced to unwind their debt positions and cut consumer spending. This trend is set to continue. Consequently, the world economy cannot count on the sort of stimulus provided by the United States in the same way as it did prior to the crisis.

In China, a transformation from investment- and export-led growth to consumer-led growth is an official policy objective. The share of labour compensation in total income in this country also fell for some time, but has risen recently. However, overall income gro th was faster than in any other economy and consumption grew rapidly, particularly over the past two years, when there was a slump in incomes and consumer spending in the other major economies. China has done more than any other emerging-market economy to stimulate domestic demand through government spending. As a result its imports have risen sharply and the current-account surplus is bound to shrink significantly in 2010.

Between 2004 and 2008, there was a sharp fall in the share of household consumption in China's GDP, reaching a low of about 35 per cent. Nevertheless, in absolute terms, the growth rates of private consumer spending have been very high since 2005. The fall in the share of household consumption was mainly the result of China's emphasis on investment and exports to fuel economic growth, and the fact that China became the hub for large-scale production by transnational corporations. Since 2009, there have been increasing signs that real wages are set to grow faster relative to productivity than in the past, and that higher government spending on social security and public investment in housing may reduce household precautionary savings. Combined with additional reforms in the financial sector, this could accelerate the increase in household consumption in China and further reduce its dependence on exports for output growth.

## Risk of a deflationary rebalancing

However, there is little reason to believe that household consumption in China, which still is only about one-eighth that of the United States, could supplant United States household consumption as a driver of global growth any time soon. The net effect of United States and Chinese adjustments taken together would be deflationary for the world economy, while they would not be sufficient to unwind the large global imbalances.

Any additional contribution to a global rebalancing will therefore have to come from other countries. To the extent that it comes from other current-account deficit economies, the impact will be deflationary, as it would have to rely on import retrenchment. As for the big oil-exporting countries, the evolution of their current-account surpluses depends largely on oil revenues, which are unstable, and the size of their domestic demand is not large enough to significantly influence trade flows and employment creation at the global level. Further domestic demand growth in other large emerging-market economies in the South would certainly help to make their industrialization and employment less dependent on export markets. It might also create a larger market for other developing countries that produce consumer goods. However, the import potential of Brazil, India, Indonesia and South Africa combined is not even equivalent to that of Germany and, with the exception of Indonesia, these countries have not had current-account surpluses in recent years.

Thus the key element in demand management worldwide would have to be expansionary adjustment in the industrialized economies that have the largest surpluses, namely Germany and Japan. However, the chances of this happening are extremely remote. In Japan domestic demand growth would need to be significantly stronger, but deflation

remains entrenched by wage cuts. In Germany, there is considerable scope for a rise in household consumption based on wage increases, which would also have expansionary effects in the rest of Europe. Such an expansion could make an important contribution to global rebalancing, as the size and composition of European imports of consumer goods are relatively similar to those of the United States. But the eagerness of EU governments to embark on fiscal consolidation programmes, exacerbated by wage cuts, makes it unlikely that a major contribution to global rebalancing and a substantial stimulus for global output and employment growth will come from this regional bloc. Thus the developing and emerging-market economies that had focused their export-oriented development strategies on the markets of the major developed economies may have to reconsider these strategies.

## Developing countries face particular employment challenges

Employment creation is a particularly difficult challenge for developing countries. Their labour force is still growing rapidly, necessitating the constant generation of additional jobs for the new entrants within an economic structure characterized by dualism. Many of these countries have a modern sector with relatively high productivity and large economies of scale, which coexists with a sluggish traditional sector with low productivity and a predominance of constant returns to scale of production activities. The processes of economic development, in general, and of employment creation for the growing population, in particular, require an expansion of modern activities and the reallocation of labour from the traditional to the modern sectors. These need to be accompanied by enhancing productivity in all economic sectors. The modern sector, where production takes place in organized units with formal wage jobs, has often been equated with industry, particularly manufacturing, but increasingly it also includes modern services and some innovative agricultural activities.

Growth in the modern sector is associated with higher private and public investment in fixed capital as well as greater government spending for the provision of education and health services and social protection. Moreover, the more productive use of previously underemployed labour through its transfer from less remunerative traditional activities to better paid jobs in the modern sector generates higher incomes and a consequent increase in effective demand. For both these reasons, the share of non-agricultural goods and services in total demand will increase over time and support the expansion of the modern sector.

But even when activities in the modern sector expand rapidly, in poorer countries this sector is often too small to create a sufficient number of new jobs to absorb all the surplus labour. It is therefore necessary that incomes grow not only in the modern, higher productivity sectors, which frequently employ a small segment of the labour force, but also in the traditional sectors. This can be achieved by including the latter in supply chains, as far as possible, and by ensuring that incomes also rise in the agricultural sector by increasing the prices of agricultural produce in line with wage incomes in the formal sector. Without such linkages, a strategy that focuses on the development of the modern sector alone may actually widen the social and economic gap and exclude a large proportion of the population from decent employment and adequate levels of consumption and social coverage.

In the 1980s and 1990s, developing countries placed a growing emphasis on production for the world market to drive expansion of their formal modern sectors. It was hoped that this could trigger and accelerate a virtuous process of output growth, and steady gains in productivity and employment. However, that hope was seldom realized. In many countries exports did not grow as expected due to a lack of supply capacities and insufficient competitiveness of domestic producers on global markets. In others where exports grew, the domestic labour force employed in export industries did not share in the productivity gains. Instead, these gains tended to be passed on to lower prices, so that domestic demand did not increase, which would have led to higher income in the rest

of the economy. As a result, employment problems persisted, or even worsened, particularly in Latin America and Africa.

## Stagnation and rising unemployment in Latin America in the 1980s and 1990s

In Latin America between 1980 and 2002, per capita GDP virtually stagnated, unemployment increased and average productivity declined due to insufficient investment in fixed capital. Most of the time macroeconomic policies focused on controlling inflation through high interest rates, thereby discouraging investment. Moreover, currency overvaluation hampered export growth and favoured the use of imported components in industrial production, leading to "premature deindustrialization". Financial liberalization and an opening up of the capital account aggravated currency misalignments and economic instability, leading eventually to economic crises. As the reduction of formal employment was greater than its creation in internationally competitive sectors, the bargaining power of wage earners weakened. Moreover, wage compression aimed at restoring international competitiveness reduced wage earners' share in income distribution, which dampened the growth of domestic demand.

It was only after the experience of the Asian financial crisis in the late 1990s and the Argentinean debt crisis in 2001–2002 that a fairly radical reorientation of macroeconomic policies occurred. Governments embarked on more accommodative monetary policies and an exchange-rate policy that aimed at preserving international competitiveness. In several countries, fiscal revenues as a percentage of GDP increased, which provided them with the necessary policy space as well as the resources to spend more on infrastructure and social transfers. At the same time, specific measures for the labour market were adopted, including sizeable rises in the minimum wage, the reactivation of collective bargaining bodies and the launching of public works

programmes. As a result, the employment situation improved from 2003 onwards, helped by a favourable international environment, in particular higher primary commodity prices and rapidly rising net imports by the United States. For the first time in almost 30 years, informal employment and unemployment receded and poverty fell significantly until 2008.

## Persistence of a large informal sector in Africa

In Africa, employment generation, and particularly the creation of high-productivity and well-paid jobs, has been even more difficult. More than 20 years of orthodox macroeconomic policies and policy reforms have had limited success in creating the conditions necessary for rapid and sustainable growth, particularly in sub-Saharan Africa. Many countries in this subregion experienced a fall in per capita GDP and manufacturing activities during the 1980s and 1990s. By the end of the 1990s, the production structure of the subregion was reminiscent of the colonial period, consisting overwhelmingly of agriculture and mining. The extent of the impact on employment was not fully reflected in official figures on open unemployment but it was evident in the 20 per cent drop in labour productivity.

The commodity boom, debt relief and the ending of a number of civil conflicts have contributed to a recovery in income growth since 2003, which has continued in recent years despite the global crisis. However, so far there is no evidence of any significant change in the pattern of employment. Official employment rates have remained high in sub-Saharan Africa, which confirms that the unsolved problem there is not a shortage of employment in absolute terms, but the lack of productive and decent employment. Agricultural employment, which is largely informal, has diminished somewhat with progressive urbanization, but it still represents more than 60 per cent of total employment. Concomitantly there has been a rise in employment – again mainly informal – in urban services and small-scale commerce.

Formal wage jobs account for only 13 per cent of employment in this subregion (excluding South Africa), and 60 per cent of the employed are "working poor", meaning that households are unable to meet their basic needs with the level of income earned. Any improvement in the employment situation resulting from a continuing trend of faster GDP growth will depend on the extent to which income growth in export industries spills over to the rest of the economy. But that in turn will depend on firms' demands for inputs, an increase in consumption of domestically produced goods, and/or a rise in government spending financed by higher taxes paid by exporters.

In North-Africa, GDP growth slowed down, labour productivity stagnated and the sectoral composition of employment remained broadly unchanged between 1980 and 2000. Employment growth was not fast enough to absorb the rapidly expanding labour force. As a result, unemployment surged to two-digit figures in the 1990s. The stronger rise in official unemployment figures in North Africa is probably due to the fact that wage earners account for more than half of those employed – a much higher share than in sub-Saharan Africa. Since 2000, the acceleration of GDP growth has helped reduce unemployment in a context of rising labour productivity. But at close to 10 per cent, unemployment is high compared to other developing regions, and remains a serious problem, especially for young people and women.

## Output growth and job creation in Asia

The experiences of East, South-East and South Asian countries with regard to employment creation over the past three decades differ considerably from those of Latin America and Africa. Faster capital accumulation, supported by low and stable interest rates, provided the basis for rapid increases in output, employment and productivity. Even so, open unemployment in South and South-East Asia increased, mainly in the 1990s, as urban job creation was not able to absorb all

migrants from rural areas. In China and India, despite the rapid growth of GDP and exports, and employment creation in modern services and manufacturing industries, a large proportion of the labour force is still employed in low-productivity and informal activities.

Generally, the Asian economies opened up more gradually to international competition, and the process took place in a more stable macroeconomic environment, where wages grew in line with productivity. However, when financial and capital-account liberalization in East and South-East Asia opened the door to inflows of speculative capital, real exchange rates became overvalued, with attendant effects on current-account balances, which triggered the financial crisis of 1997–1998. The crisis-affected countries experienced a sharp rise in unemployment and a dramatic fall in GDP growth rates, and although the latter have picked up, particularly since 2002, they have not reached their pre-crisis levels. In most South-East Asian countries manufacturing output has been growing at less than half the rates recorded prior to the crisis.

## Neglected role of domestic demand growth for employment creation

High rates of unemployment are often attributed to rigidities in the labour market that prevent wages from falling to an equilibrium level at which all excess labour would be absorbed. However, there is no empirical foundation for the proposition that the level of employment depends on the price of labour relative to that of capital. On the other hand, it can be shown that employment creation is closely associated with output growth and fixed capital formation. This means that unsatisfactory labour market outcomes are primarily due to unfavourable macroeconomic conditions that inhibit investment in fixed capital and productivity growth, as well as to inadequate growth of labour income, which constitutes the most important source of domestic demand.

There is clear evidence that in both developed and developing economies with relatively large formal manufacturing and service sectors employment generation is positively correlated with GDP growth and with investment in fixed capital. This suggests that the main consideration of entrepreneurs, in terms of its relevance for employment, is not one of choosing between varying combinations of capital and labour at a given level of output, but rather, deciding whether prevailing demand expectations are such that an increase in production capacities can be expected to be profitable or not. If the expectation is positive, they will invest in labour and capital at the same time. In many developing countries, the statistical link between an increase in employment, on the one hand, and in output and investment growth, on the other, is weaker. This is probably because a much larger proportion of the labour force is in informal employment and self-employment, which serve as buffers between productive formal employment and a status that can be defined and measured as unemployed.

Due to strong global competition and an increasing reliance on external demand, a major concern of both governments and companies in the tradables sector is the maintenance and strengthening of international competitiveness. This has induced a tendency to keep labour costs as low as possible. But if exports do not rise as expected, because other countries pursue the same strategy, or if the production dynamics in export industries do not spill over to other parts of the economy, as in many developing countries – especially in Africa and Latin America – these measures can be counterproductive for sustainable employment creation.

Given the close links between employment, output and demand growth, a strategy of keeping wages low in order to generate higher capital income to motivate fixed investment or reduce product prices in order to gain a competitive edge can be self-defeating. This is because if wages grow at a slower rate than productivity, the supply potential may end up growing faster than domestic demand, thereby discouraging innovation and productive investment.

Allowing a shrinking of the wage share is unlikely to lead to the desired outcome, unless investment and output growth are extremely dynamic. This has been the case in China in recent years. In this country, strong productivity growth was associated with two-digit increases in wage levels and a rapid growth of private consumption. The crisis since 2008, as with other – though milder – recessions in the industrialized countries before, has also revealed the limits of relying on external markets for growth and employment generation. Even if the world economy continues along its recovery path in the near future, it is unlikely that the external environment for developing countries will again be as favourable as it was in the years preceding the crisis.

## Why labour income should be linked to productivity growth

In this environment, achieving more satisfactory outcomes for employment creation – and thus also for poverty reduction – requires widening the scope of policy instruments beyond what was deemed appropriate under the development paradigm of the past 30 years. Serious consideration of strategies to enhance domestic demand as an engine for employment creation is warranted for three reasons. First, the employment performances of different groups of developing countries suggest that the policy prescriptions of the past, which relied primarily – in some cases exclusively – on liberalization of product, financial and labour markets, did not lead to satisfactory levels of employment creation. Second, there is the risk of a deflationary trend in the global rebalancing process due to adjustments in the level and structure of demand that are likely to occur in the two largest economies, China and the United States. This darkens the outlook even for those developing and emerging-market economies that in the past successfully based their growth on an expansion of exports rather than domestic demand. Third, theoretical considerations suggest that a strategy of export-led growth based on wage compression, which makes countries overly

dependent on foreign demand growth, may not be sustainable for a large number of countries and over a long period of time. This is because not all countries can successfully pursue this strategy simultaneously, and because there are limits to how far the share of labour in total income can be reduced.

A promising strategy for rapid employment generation could be to focus more on investment dynamics, and to ensure that the resultant productivity gains are distributed between labour and capital in a way that lifts domestic demand. This strategy was successfully pursued in most developed countries during the so-called "golden age of capitalism" between 1950 and 1973, when unemployment was at historically low levels. Labour markets were generally much more regulated than today, but central banks in nearly all developed countries were made responsible not only for maintaining price stability, but also for ensuring a high level of employment. Accordingly, real interest rates were kept low, thereby providing favourable financing conditions for investment in fixed capital. This was supplemented by financial support from public entities, along with government guarantees for bank loans, and interest subsidies for selected industries and investment projects. In addition, centralized wage negotiating mechanisms helped to ensure that productivity gains were translated into both higher profits, which stimulated innovation and investment, and higher wages, which strengthened mass purchasing power. At the same time, these mechanisms were instrumental in keeping unit labour costs from rising, and thus helped control inflation.

Although the context and circumstances differ in today's world, this strategy holds useful lessons for the design of macroeconomic and development strategies for developing countries. It can help generate an increase in demand for consumer goods and services, which would create additional demand for labour on the part of the producers of those goods and services that is sufficiently large to compensate for possible lay-offs of workers in those firms where productivity has increased. This is of particular importance for developing countries where most, if not all, capital goods have to be imported, so that the production of those

capital goods does not itself create any domestic employment. However, through its effect on aggregate demand, a regime in which labour income rises in line with productivity is also supportive of investment, innovation and further gains in productivity. This is because it is the experience and expectation of rising demand, rather than a reduction in unit labour costs, which drives investment in additional or enhanced productive capacity. And such investment is a precondition for the absorption of the labour surplus in new productive activities.

The incentive for dynamic entrepreneurs to invest in fixed capital and product or process innovation is even stronger if wages follow the average productivity growth of the entire economy, rather than if the wages in each firm follow the productivity growth of that firm. The former would result in a greater differentiation of profits between capitalist firms. More dynamic entrepreneurs would be rewarded for their investments or innovations with higher pioneer rents than in a situation where they pass on the gains from their firms' enhanced productivity either to their own workers or to their customers through price reductions.

## Broadening the scope of policy instruments

In the midst of the financial crisis, most governments have rediscovered the role of countercyclical fiscal policy in stabilizing aggregate demand, as reflected in the unprecedented stabilization packages that were launched to prevent another Great Depression. It would be extremely beneficial for growth and employment if the principles underlying these policy decisions continued to serve as a basis for a revised approach to fiscal policy. The public sector, as the largest purchaser of goods and services and the largest employer, has a significant influence on the expansion and functioning of goods and labour markets. Thus, if its behaviour is governed by the same principles

as those of private agents, it amplifies economic fluctuations and leads to a crisis of confidence.

Moreover, governments can levy taxes on the modern sector and on highly profitable export activities to enable the provision of State financial support for productivity growth and income generation in the traditional and informal sectors. As a result, important linkages can be established between successful export industries, on the one hand, and the rest of the economy on the other. This is all the more important when such linkages are not created by market forces owing to the structural heterogeneity of a developing economy. For example, effective taxation of extractive industries' profits may often be the only way that the windfall profits resulting from an increase in international commodity prices can be channelled back into domestic demand and into greater investment in diversification of production and job creation.

## Employment-friendly monetary and financial policies

While the prevention of excessive inflation is undoubtedly important, a monetary and financial policy to promote employment creation through greater fixed investment is of particular importance for developing countries where investment dynamics are weak, but where the enlargement of productive capacity and productivity growth are necessary conditions for the absorption of surplus labour. An employment-friendly monetary policy would aim at maintaining low costs of credit for investment in fixed capital and avoiding currency appreciation.

Financial policies should enable credit to be directed to sectors and activities that are of strategic importance for the structural transformation of the economy as a whole. Such financial support, which has often been used as an instrument of industrial policy, could

also help solve the problem of access to adequate financing faced by many small, innovative enterprises, including those in the informal sector and agriculture. Many of these enterprises can play a key role in creating employment and linkages between modern and traditional production activities. Examples of such policies include the direct provision of credit by public financial institutions or by intervention in financial markets through such measures as interest subsidies, the refinancing of commercial loans and the provision of guarantees for certain types of credit.

## Controlling inflation more effectively through an incomes policy

By shifting the emphasis of monetary policy towards growth and employment creation, the scope for central banks to pursue the objective of maintaining price stability or low inflation will be reduced. Therefore an additional instrument will be necessary to control inflation. This can be provided by an incomes policy. In the same way as it can contribute to generating greater domestic demand, such a policy can also prevent labour costs from rising faster than productivity and thus serve to control inflation.

As labour costs are the most important determinant of the overall cost level in a vertically integrated market economy, their importance in helping to stabilize the inflation rate cannot be overemphasized. If an incomes policy were to succeed in aligning wage income growth with average productivity growth plus a targeted inflation rate (not based on indexation from past inflation rates), cost-push inflation could be controlled. It would keep inflation low by preventing both increases in real production costs and demand growth in excess of the supply potential. Thus, central banks would not have to keep interest rates high to combat inflation, and consequently there would be more space for a growth-oriented monetary policy.

This is especially true for developing countries, many of which have a history of very high inflation. Backward looking indexation of nominal wages frequently contributed to bouts of inflationary acceleration. This has proved to be extremely costly, because the only way central banks can cut inflation is by applying repeated shocks to the economy through interest rate hikes and currency revaluations. Such measures imply sacrificing real investment and employment for the sake of nominal stabilization.

## Institution building and public sector involvement in creating a wage-employment nexus

Alternative policy approaches for faster employment creation will have to take into account institutional frameworks that differ widely, even among countries at similar levels of per capita income. On the other hand, sustained employment creation may require reforms in these institutional conditions themselves.

Indeed, building the kind of institutions that would facilitate a productivity-led growth of labour income could be the basis for a successful development strategy that gives priority to employment creation and poverty reduction. A key element of such a strategy can be the creation and empowerment of trade unions, which should not only represent the interests of workers but also contribute to growth dynamics and macroeconomic stability. But in order to prevent an acceleration of inflation, nominal wage increases must not be adjusted to past consumer price inflation that may have resulted from increases in the prices of imported goods. Rather, the rule should be to link increases in labour compensation to past productivity increases plus a rate of inflation that is considered acceptable after taking into account price increases of imports.

This rule should ensure that the share of wage income in total income does not fall, as has frequently been the case in many countries

in the past. However, situations may arise where an increase in the share of wage income is desirable. In this case, more far-reaching adjustments of labour compensation could be subject to explicit negotiations as part of a social compact. But as such a change in the functional distribution of income will often be difficult to achieve, governments may have to resort to an array of instruments to influence personal income distribution in order to correct perceived social inequalities.

Tripartite arrangements, including, for example, government recommendations for wage increases, have helped a number of countries in the past to achieve a steady increase in domestic demand. At the same time, economic policy has focused on directing investment into fixed capital, preventing undue inflationary pressure and preserving the international competitiveness of domestic producers. In the absence of, or as a complement to, a centralized negotiating mechanism for labour compensation for the entire economy, the introduction of a minimum wage and its augmentation over time, in line with productivity growth, may also help to ensure that domestic demand and the domestic supply potential rise approximately in parallel.

Since employment outside formal manufacturing and service activities constitutes a large share of total employment in most low-income developing countries, greater efforts should be made to improve earnings as well as working conditions in this segment of the economy. One way of doing this is to implement public employment schemes that establish an effective floor to the level of earnings and working conditions by making available jobs that offer such minimum employment terms.

Equally important are productivity-enhancing and income-protection measures in agriculture and the informal sector for a number of reasons besides raising income levels in such activities: they can also help strengthen the capacity of small-scale entrepreneurs or the self-employed to invest in productivity-enhancing equipment and increase demand by this segment of the population for consumer goods that are produced locally. In this context, improving and stabilizing farmers'

incomes, as has been the practice in practically all developed countries for decades, is essential for enabling agricultural producers and workers to participate in economy-wide productivity and income growth. This will require a revitalization of agricultural support institutions and measures to reduce the impact on farmers' incomes of highly subsidized agricultural products imported from developed countries.

## The external dimension

All these measures taken together would provide considerable scope for demand management to combat unemployment while keeping inflation in check and reducing export dependence. Especially for developing countries, broadening the menu of policy instruments and institution building would allow not only the pursuit of additional goals, but also increase the possible combinations of instruments, which in many cases will be decisive for the success or failure of a development strategy. However, a strategy of employment generation based on an expansion of domestic demand in line with productivity growth is more likely to succeed if it is embedded in a favourable coherent international policy framework.

There will be greater scope for central banks to pursue an investment-friendly monetary policy when disruptions in the financial sector and currency volatility and misalignment through speculative international capital flows are minimized. This is a systemic problem which could be solved through an appropriate multilateral framework for exchange-rate management that aims to prevent large current-account imbalances by keeping the real exchange rate relatively stable at a sustainable level. Such an exchange-rate scheme would also reduce the risk of employment losses in some countries due to undervaluation of the real exchange rate in others. In the absence of effective multilateral arrangements for exchange-rate management, the use of capital-account management techniques can contribute to regaining greater autonomy in

macroeconomic policy-making, as has been done in various emerging-market economies.

A refocus on strengthening domestic demand as an engine of employment creation, and relying less on exports for growth than many countries did in the past should not be viewed as a retreat from integration into the global economy. Developing countries need to earn the necessary foreign exchange to finance their required imports, especially of capital goods with their embedded advanced technologies. Moreover, international competition can also spur innovation and investment by producers in tradable goods industries.

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